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Raising the Minimum Wage: The Effects on Employment, Businesses and Consumers

As the United States struggles to recover from the most recent recession, policymakers at the federal, state and local levels of government are considering solutions to help America's less fortunate. One suggestion gaining traction is to increase the minimum wage rate at federal and state levels. Despite good intentions, this proposal will hurt lower-income, less-experienced and less-educated Americans. Furthermore, it will place an additional burden on businesses, especially small business owners struggling in the current economy.

Minimum Wage: A Primer

Congress instituted the federal minimum wage as part of the Fair Labor Standards Act (FLSA) in 1938. However, states and local government entities, such as cities and counties, have the authority to set their own minimum wages above the federal level. As a result, effective minimum wage rates vary across jurisdictions. Led by Washington state at $9.32 per hour, Oregon at $9.10 per hour and Vermont at $8.73 per hour, 21 states and the District of Columbia have a minimum wage rate higher than the federal wage rate of $7.25 per hour. Twenty states have wage rates equal to the federal wage rate. The remaining nine states have a lower wage rate, but employers must pay the higher federal rate.[1] In 2012, only 4.7 percent of hourly-paid employees earned the federal minimum wage or less.[2]

Employers will be forced to make tough decisions to absorb the mandated increase to production costs. This often takes the form of decreased hiring or reduced hours, which has negative employment effects in an already tough job market. Raising the minimum wage favors those who already have jobs at the expense of the unemployed. While some workers receive a marginal addition to their wages, others—usually less educated or experienced—are left unable to find employment.

Despite evidence that increasing the minimum wage negatively affects the people it is intended to help, advocates at the federal, state and local levels continue to call for increases. Recently, President Barack Obama raised the minimum wage for all federal contractors to $10.10 per hour and called on Congress to raise the federal minimum wage for all employed people; advocates in states as diverse as Alaska, Idaho, Massachusetts, Maryland and South Dakota have lobbied for an increase to state wage rates; and surrogates for fast-food and retail workers have staged strikes to demand as much as $15 per hour. These

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States	Minimum Wage
Alabama	N/A
Louisiana	N/A
Mississippi	N/A
South Carolina	N/A
Tennessee	N/A
Georgia	$5.15
Wyoming	$5.15
Minnesota	$6.15
Arkansas	$6.25
Delaware	$7.25
Hawaii	$7.25
Idaho	$7.25
Indiana	$7.25
Iowa	$7.25
Kansas	$7.25
Kentucky	$7.25
Maryland	$7.25
Nebraska	$7.25
New Hampshire	$7.25
North Carolina	$7.25
North Dakota	$7.25
Oklahoma	$7.25
Pennsylvania	$7.25
South Dakota	$7.25
Texas	$7.25
Utah	$7.25
Virginia	$7.25
West Virginia	$7.25
Wisconsin	$7.25
Michigan	$7.40
Maine	$7.50
Missouri	$7.50
New Mexico	$7.50
Alaska	$7.75
Arizona	$7.90
Montana	$7.90
Florida	$7.93
Ohio	$7.95
California	$8.00
Colorado	$8.00
Massachusetts	$8.00
New York	$8.00
Rhode Island	$8.00
Illinois	$8.25
Nevada	$8.25
New Jersey	$8.25
Connecticut	$8.70
Vermont	$8.73
Oregon	$9.10
Washington	$9.32

Source: United States Department of Labor, Wage and Hour Division

calls pose a serious threat to America's small businesses and to the very individuals the minimum wage is aimed to help.

As the minimum wage debate is brought to state legislatures around the country, policymakers must be prepared to engage an issue fraught with political landmines. This report provides facts about raising the minimum wage and gathers research to inform the debate.

> Raising the minimum wage favors those who already have jobs at the expense of the unemployed.

The Employers: Increased Costs for Businesses

When the government imposes a higher minimum wage, employers face higher labor costs and are forced to respond by decreasing other production expenses.[3] Some employers make labor-saving capital investments that reduce reliance on employees, decrease pay raises to employees that earn more than the minimum wage, or replace the lowest-skilled individuals with more highly skilled employees.[4] Other firms may make adjustments such as reducing employees' hours, non-wage benefits or training.[5]

Businesses cannot afford to pay employees more than those employees produce on the aggregate. Employees who are paid the minimum wage earn that wage rate because they lack the productivity to command higher pay.[6] Advocates of increasing the minimum wage rely on the idea that businesses are able but unwilling to pay higher wages to their employees. The hope is that these businesses will simply take a hit in their profits while employment and prices are negligibly affected. Unfortunately, most minimum wage earners work for small businesses, rather than large corporations.[7] According to an analysis by the Employment Policies Institute, roughly half of the minimum wage workforce is employed at businesses with fewer than 100 employees, and 40 percent work at businesses with fewer than 50 employees.[8] Small businesses face a very competitive market and often push profits as low as they can go to stay open. Minimum wage earners employed by large corporations would also be affected, because these corporations are under tremendous pressure from shareholders to keep costs low.

Last year, the California chapter of the National Federation of Independent Business (NFIB) projected the potential negative effects of the state's 2013 legislation that raises California's minimum wage rate to $9 per hour in 2014 and again to $10 by 2016.[9] It estimated the increase to the wage rate would shrink the California economy by $5.7 billion in the next 10 years and result in approximately 68,000 jobs being cut from the state. It further projected that 63 percent of the estimated 68,000 jobs lost would be from small businesses that could no longer afford to pay their employees.[10]

The bottom line is that someone must pay for the costs associated with an increased minimum wage. Often, because a business cannot pay these costs, they are paid for by the individuals the minimum wage is intended to help—low-skilled, undereducated individuals—as they lose out on job opportunities.

Higher Unemployment: Why raising the minimum wage negatively affects employment

Under the basic neoclassical competitive market model—used most frequently to study the effects of the minimum wage—increasing the price of a good or service decreases demand for that good or service.[11] In the case of wage rates, if the government increases the price of labor by raising the minimum wage, employers will demand less of it.

Although most economic research since the advent of the minimum wage has found that increases to the minimum wage reduce employment, the effect of minimum wage laws on employment levels continues to be one of the most studied questions in economics.[12] Earlier research examining the minimum wage's effects on employment used time-series data and variation in the national minimum wage. The results of this research show increases to the minimum wage tend to reduce employment levels. In the 1990s, however, economists began to use the variation in state minimum wage levels to determine the effect of minimum wage increases on employment. The results of the 1990s research were more controversial; some studies had similar results to earlier research, others found no effect or even significant positive effects on employment, and others showed even stronger negative effects of increasing the minimum wage.[13]

However, the main conclusion of more than seven decades of research is that minimum wage increases tend to reduce employment.[14] One review by economists David Neumark and William Wascher shows that 63 percent of studies found relatively consistent evidence of negative employment effects on minimum wages.[15] Further, 85 percent of what they deem the most reliable studies point to negative employment effects.[16]

Four Common Misconceptions of the Minimum Wage

1} ***Misconception:** Raising the minimum wage will lift families out of poverty.*

TRUTH: The problem plaguing America's poor is not low wage rates, but a lack of job opportunities. Minimum wage increases fail to alleviate poverty because they fail to address unemployment. Recent studies have shown that there is little to no relationship between an increased minimum wage and reductions in poverty.[i] These studies find that, although some lower-skilled workers living in poor families see their incomes rise when the minimum wage increases, others lose their jobs or have their hours substantially cut.[ii]

2} ***Misconception:** Minimum wage earners are supporting families on their minimum wages alone.*

TRUTH: Among adults 25 and older earning minimum wage, 75 percent live well above the poverty line of $22,350 for a family of four, with an average annual income of $42,500.[iii] This is possible because more than half of older minimum wage earners work part-time, and many are not the sole earners in their households.[iv] In fact, 83.5 percent of employees whose wages would be increased by a minimum wage hike either live with parents or another relative, live alone, or are part of a dual-earner couple.[v] Only 16.5 percent of individuals who would benefit from an increase to the minimum wage are sole earners in families with children.[vi]

3} ***Misconception:** Minimum wage increases stimulate the economy through increased consumer spending.*

TRUTH: Research has found no link between an increased minimum wage and economic growth. One study found that, while minimum wage increases have no effect on GDP generated by more highly-skilled industries, there may be small to modest declines in GDP generated by lower-skilled industries.[vii]

4} ***Misconception:** Minimum wage earners are trapped in poverty.*

TRUTH: Minimum wage jobs are viewed by many as the first step in a long career path. Nearly two-thirds of minimum wage earners gain pay raises within the first year of employment.[viii] From 1981 to 2004, the median annual growth in wages for minimum wage employees was nearly six times that of employees earning more than the minimum wage.[ix]

(Footnotes)

i. Sabia, Joseph J., and Richard V. Burkhauser. "Minimum Wages and Poverty: Will a $9.50 Federal Minimum Wage Really Help the Working Poor?" *Southern Economic Journal*. 2010. 76 (3), 594.

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iii. Sherk, James. "Who Earns the Minimum Wage? Suburban Teenagers, Not Single Parents." *The Heritage Foundation*. February 28, 2013. Available: http://www.heritage.org/research/reports/2013/02/who-earns-the-minimum-wage-suburban-teenagers-not-single-parents.

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A recent study by the Heritage Foundation concluded that the current proposal before Congress to raise the federal minimum wage from $7.25 to $10.10 per hour would likely eliminate an estimated 300,000 jobs per year and lower the national gross domestic product by an average of $40 billion per year.[17]

The negative effects on employment are likely to be more profound in the long run, as employers shift to labor-saving methods of production when labor costs rise.[18] ATMs have replaced many bank tellers, cashiers have been swapped for self-serve checkouts at grocery and convenience stores, and gas jockeys have been eliminated in most areas where they are not legally mandated. In occupations where most work is repetitive, it is cost-effective for an employer to respond to higher labor costs by substituting technology for employees. This means occupations consisting of routine tasks—the jobs most likely to be held by less experienced and less educated individuals—are also the most likely to be replaced by technology as employers make investments to adapt to higher labor costs associated with an increased minimum wage.

> "What you are doing is to assure that people whose skills are not sufficient to justify that kind of wage will not be employed. Minimum wage law is most properly described as a law saying employers must discriminate against people who have low skills."
> **– Milton Friedman**

Even if employers do not decrease hiring, they will respond to higher labor costs by replacing the lowest-skilled individuals with more highly-skilled employees, which prices inexperienced workers out of the market. Further, the higher pay attracts more affluent individuals to enter the low-wage labor market, such as teenagers from well-off families or adults looking to provide a secondary income to their households. The increased labor supply makes it even more difficult to secure minimum wage jobs for those who most need them. According to testimony provided by James Sherk of the Heritage Foundation, after minimum wage levels increase, businesses employ more teenagers living in affluent zip codes and fewer teenagers from lower-income zip codes.[19]

Although increases to the minimum wage encourage more teenagers to attempt to join the workforce, mandated wage increases limit the number of job opportunities available to them at a time when teenage unemployment rates are already at a staggering 20 percent.[20] For many young people looking for a job, the primary value that employment provides is on-the-job training, rather than the initial low pay. More than 60 percent of young employed earners are enrolled in school during non-summer months, and for 79 percent of them, it is a part-time job.[21] Minimum wage jobs can often serve as a stepping stone to later career goals, so young earners are often more likely to need experience in basic job skills than a small wage increase. Increasing the minimum wage and removing job opportunities from teenagers and young adults could suppress their wage-earning abilities later in life when they are more likely to need their wages to support a family.[22]

The effects on employment are even more pronounced for minority youth. A 10 percent increase in the minimum wage decreases minority employment by 3.9 percent, with the majority of the burden falling on minority youth whose employment levels will decrease by 6.6 percent.[23]

Inflationary Effects: Artificially higher prices hurt consumers

However, negative employment effects are not the only consequence of raising the minimum wage. Employers often cannot fully absorb the costs of an increased mandated wage rate by cutting their workforce because they need that labor to successfully run their businesses. Employers are forced to turn to other methods to protect their bottom line and stay in business.

The costs of a minimum wage hike are often passed on to consumers in what economist Daniel Aaronson calls “price pass-through.” In a study of prices in the restaurant and fast food industry—an industry that heavily employs and serves low-wage earners—Aaronson, French and MacDonald found an increase in the minimum wage also increases the prices of food items.[24] Using data from the Consumer Price Index (CPI) from 1995 to 1997, the economists examined 7,500 food items (usually a complete meal) from 1,000 different establishments in 88 different geographic areas. They found the increase in menu prices affected limited service restaurants the hardest. These are restaurants where most diners pay at the counter and take their food home with them. These restaurants are also more likely to employ low-wage workers and thus more likely to have their business costs rise as a result of a minimum wage increase. The study found that in these instances, almost 100 percent of the increase in labor costs is passed on to consumers in the form of higher prices.[25]

These results are consistent with most of the economic literature on the subject. Sara Lemos of the Institute for the Study of Labor (IZA) looked at more than 20 papers on the subject and found that most studies predicted a 10 percent increase in the minimum wage would result in a 4 percent increase in food prices and a 0.4 percent increase in prices overall.[26]

Unfortunately, the businesses hit hardest by an increase to the minimum wage are not only the types of places where low-income people are employed, but also businesses frequented by low-income consumers. Food prices are of particular importance to people living near or below the poverty line as they tend to spend a greater percentage of their family budget on food.

The low-wage employees who experience an increase to their wages due to a minimum wage increase will have the benefit of higher wages largely offset by higher prices. Additionally, non-minimum wage earners will face higher prices without the corresponding increase in wages. Thus, they will likely cut back spending to compensate. These cutbacks in spending may also result in substitutions toward cheaper, lower quality goods.

Daniel Aaronson and Eric French predicted a $25 billion drop in spending from those earning above minimum wage if the minimum wage was increased from $7.25 to $9.00 per hour.[27] It is worth noting that overall they expect spending to rise in the short run (due to increased spending from minimum wage earners), but they also expect GDP to remain constant in the long run.

Conclusion: Increasing the Minimum Wage Will Hurt the Exact People it is Meant to Help

Proponents of minimum wage increases often justify their support for the policy with the belief that it will raise America’s least fortunate out of poverty. However, past minimum wage increases have not helped achieve this goal.[28] Although helping the poor is a worthy pursuit for policymakers, if the goal is to help the poor, raising the minimum wage is an inefficiently targeted policy.

Recent studies have shown that there is little to no relationship between increases in the minimum wage and reductions in poverty.[29] These studies find that, although some lower-skilled workers living in poor families see their incomes rise when the minimum wage increases, others lose their jobs or have their hours substantially cut.[30] Economists Joseph Sabia and Richard Burkhauser found that workers living in households below the poverty line received few of the benefits of past minimum wage increases. Even assuming that no minimum wage workers are laid off or have their hours reduced, they found only 10.5 percent of the benefits of a potential federal minimum wage increase would go to individuals living below the poverty line. More than 60 percent of the benefits would help families living at more than 200 percent of the poverty level.[31] A recent Congressional Budget Office (CBO) report examining the proposed federal minimum wage increase to $10.10 by 2016 found that, although the proposal would move approximately 900,000 people above the poverty threshold (of the estimated 45 million currently below that threshold), just 19 percent of the increased earnings would go to families below the poverty line.[32] The same report found that an increase to $10.10 would reduce total employment by approximately 500,000 workers.[33]

> The problem plaguing America's poor is not low wages, but rather a shortage of jobs.

The problem plaguing America's poor is not low wages, but rather a shortage of jobs.[34] At a time when the nation's workforce participation is only 62.8 percent, policymakers must avoid policies that destroy job opportunities.[35] Increasing the minimum wage does nothing to help the unemployed poor. In fact, as discussed above, it hurts individuals looking for employment as it decreases available job opportunities.

So, who is helped by an increase to the minimum wage?

According to a 2012 report from the Bureau of Labor Statistics, although workers under age 25 represented only 20 percent of hourly wage earners, they made up just over half (50.6 percent) of all minimum wage earners.[36] The average household income of these young minimum wage earners was $65,900.[37] Among adults 25 and older earning the minimum wage, 75 percent live well above the poverty line of $22,350 for a family of four, with an average annual income of $42,500.[38] This is possible because more than half of older minimum wage earners work part-time and many are not the sole earners in their households.[39] In fact, 83.5 percent of employees whose wages would rise due to a minimum wage increase either live with parents or another relative, live alone, or are part of a dual-earner couple.[40] Only 16.5 percent of individuals who would benefit from an increase to the minimum wage are sole earners in families with children.[41]

With national unemployment still hovering around 7 percent, national, state, and local demands for an increased minimum wage could not be more ill-timed.[42] Increasing the minimum wage would make it more difficult for emerging businesses to expand payrolls and for existing businesses to maintain employees. Further, a higher wage rate would make it more difficult for individuals with less education and experience to find work. Raising the minimum wage favors those who already have jobs at the expense of the unemployed.

Public policy would be more beneficial if it lowered barriers to entry for employment and increased economic opportunities. Raising the minimum wage may be a politically attractive policy option, but it is harmful to the very people policymakers intend it to help.

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